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RUEHRC/DEPT OF AGRICULTURE WASHDC
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SENSITIVE

DEPT FOR AF/E, AF/EPS, EEB/IFD/OMA
DEPT ALSO PASS TO DOT FOR CONNIE HUNTER
DEPT ALSO PASS TO USTR FOR BILL JACKSON
DEPT ALSO PASS TO DOL FOR MICHAEL MURPHY
TREASURY FOR FINCEN
TREASURY FOR VIRGINIA BRANDON

SIPDIS

E.O. 12958: N/A
TAGS: ECON ETRD EAGR ELAB PGOV EFIN KE
SUBJECT: KENYA: WHAT A DIFFERENCE AN ELECTION MAKES

¶1. (U) Summary: In a stunning reversal from consensus predictions that the December 27 general election would not affect Kenya's growing economy, allegations of vote rigging led to inter-tribal violence and looting that temporarily paralyzed the country's transportation system, scared away tourists, and closed businesses. At a minimum, the unrest led to nearly a billion dollars in short-term revenue losses, and this doesn't yet count the destruction of businesses, homes, crops, and infrastructure. The Government of Kenya (GOK) insists the economy can stay on track and grow by 7% in 2008, but independent economists believe growth will drop to between two and five percent. Some foresee a scenario in which loan defaults and delinquencies will reduce bank liquidity and lending, all of which could lead to a recession. The GOK could add fuel to this fire if it chooses or is forced to expand domestic debt issuance to stimulate the economy and/or simply cover a budget gap which was already large before the crisis began. Any economic scenario is possible at this point, but all depend on whether, when and how the political crisis is resolved. End summary.

Billion Dollars Lost Just in Short-Term

¶2. (U) Facts and figures on the immediate economic losses due to post-election unrest continue to trickle in through the media, and from both official sources and anecdotes. The only global figure for revenue losses came on January 9 from Finance Minister Amos Kimunya, who estimated at the time that the economy had lost Ksh60 billion ($925 million) in lost production, not counting the destruction and looting of businesses and infrastructure. This is probably a conservative estimate given the source, but still amounts to a substantial chunk of Kenya's annual national income (about 4% if one uses the World Bank's $21 billion GDP estimate for 2006). Revenue losses appear spread out across the country and the economy, but two critical sectors in terms of income and employment have been especially hard hit.

Tourism: Suddenly Down and Out Again

¶3. (U) Tourism is critical to Kenya's short, medium-, and long-term economic prospects. It is the country's leading foreign exchange earner and employs 250,000 workers directly and another 550,000 indirectly. Each of these workers is estimated to support 10 family

members on average. The post-election violence has had a dramatic negative impact on a sector that before the election was booming and that had nearly recovered from the 1998 U.S. Embassy bombing and later terrorist attacks on tourist facilities in 2002. A clearly dejected Kenya Wildlife Service (KWS) Director Julius Kipng'etich reported to USAID/Kenya on January 14 that:

-- The industry "is down 90% and falling;"
-- KWS is in "dire straits" and is asking the Government for KSh1 billion to cover costs over the next six months because of lost tourism revenues;
-- The industry will take two years to recover if the political impasse is not resolved within a few weeks.

¶4. (U) The Kenya Tourist Board publicly confirmed this dire assessment, noting that 90% of tourist bookings for January have been cancelled. KTB has reduced its forecast for the first quarter of 2008 from 314,000 arrivals to 114,000, and revenues from Sh24 billion ($370 million) to Sh8 billion ($123 million) - and this assumes the situation does not degenerate further. The Kenya Association of Tour Operators (KATO) reports that major airlines and charters flying from Europe to Mombasa have been losing over $1.2 million a week. On January 17, KATO raised to Sh20 billion ($308 million) the estimated loss to the economy in the first quarter of ¶2008. Hotels on the Coast have gone from 80% or more occupancy to less than 30%. Nairobi hotels are at only 15-35%. Tourism industry officials have warned that some overseas tour operators have cancelled irrevocably for 2008, diverting tourists to other destinations, and others would follow suit if the unrest continues.

¶5. (U) As a result of this rapid evaporation of visitors, large number of jobs are now at risk. The Kenya Tourist Board (KTB) has said about 20,000 direct jobs have been lost already in tourism, and that up to 120,000 direct jobs could be lost by March.

Agriculture Also at High Risk

¶6. 4. (U) Subsistence and commercial agriculture employs as much as 80% of Kenya's workforce and contributes 25% to its GDP every year. It is the mainstay of the economy, but has been hit badly by the post-electoral unrest. While it is still too early to know the cumulative long-term effects, the severe short-term impacts include:

-- Maize: A key staple, maize production has been hit badly, especially in the Rift Valley, where ethnic violence has been the most severe and where 60% of Kenya's maize is produced. Thirty percent of Rift Valley maize, worth KSh 3.4 billion ($52 million), was lost during the unrest - burned either in fields or in storage. Another 50% would have been in the supply chain by now, but remains locked up either un-harvested or in storage due to insecurity on the roads.

-- Horticulture: This subsector, a key export earner, has lost Ksh 2.5 billion ($39 million) because of road closures and increased airfreight charges.

-- Dairy: 10 days of production, 3.4 million liters, went to waste in the Rift Valley, Kenya's dairy center, losing Ksh 678 million ($10.4 million) in household farm income. New Kenya Cooperative Creameries reported losing Ksh 60 million ($923,000) in sales because the paralysis in transportation and a lack of furnace oil forced the temporary closure of eight creameries in the Rift Valley.

-- Tea: The closure of 14 tea factories in Nandi District due to violent attacks on workers and road closures cost over Sh10 billion (about $154 million), and losses in Kericho District were reportedly comparable. The tea auction in Mombasa was cancelled in the first week of January. That said, the Kenya Tea Development Agency (KTDA) said about 60% of its producers were unaffected by the violence, and the Mombasa tea auction reopened on January 7.

Transport: A Vulnerable Lifeline

¶7. (U) The immediate revenue losses occurring after the outbreak of unrest were caused less by destruction than by a breakdown in road

transport around the country. Fearing for the safety of their rigs and drivers, owners simply withdrew their trucks, especially fuel tanker trucks, from the roads in the days following the disputed election. Together with the damage to Rift Valley Railways track near Nairobi's Kibera slum, this temporarily decimated commerce within Kenya, and between Kenya and her neighbors, causing short-term shortages of fuel and other key commodities domestically and in Uganda, Rwanda, Burundi, and South Sudan. However, as of mid-January, road transport services had returned to near normal levels thanks to efforts by the police and military to clear roads and by the police to provide armed escorts to truck convoys. However, the experience has shown just how vulnerable the economy is to a de-facto transport lock-down should violence again flare up.

Impact on Growth: The Jury's Out

¶8. (U) Given uncertainties over how long the political crisis will drag out, predictions on how it will impact growth in 2008 vary widely and are heavily caveated. In the optimist's camp is Finance Minister Kimunya, who claims the Kenyan economy will achieve its projected 7% growth in 2008. Kimunya also claimed the Ksh 20 billion (about $307 million) surplus from the privatization of Telkom Kenya in late 2007 would cover any lost tax revenues and avoid the need to increase domestic borrowing.

¶9. (U) Echoing Kimunya, Central Bank of Kenya (CBK) Governor Njuguna Ndung'u called the crisis a short disruption that would not have a major impact on GDP growth, trigger a recession, or change Kenya's long term positive growth trajectory. He conceded that supply constraints would trigger inflation in the short term, but said reconstruction will later compensate and boost growth. The CBK, he said publicly, will continue its short term tightening of monetary policy to manage excess liquidity in the economy, but does not foresee any drastic change in interest rates because the Government's domestic borrowing operations have been and will remain minimal in the first half of 2008. Ndung'u said it's too early to assess whether the crisis will lead to a significant rise in non-performing loans, but the CBK does not foresee any risk of either public or private loan defaults because it expects commercial banks and their private sector customers to develop rescue packages.

¶10. (U) Others dispute these rosy assessments. Professor Terry Ryan, a respected local economist and member of the Central Bank's Monetary Policy Advisory Committee, said a preliminary assessment shows that the agricultural, financial services and tourism sectors, representing 31% of GDP, are likely to under-perform, dragging the 2008 growth forecast down from 7% to only 2-4.5%, even if the situation returns to normal soon. The Institute of Certified Accountants (ICPAK) likewise doubts Kimunya's claims, citing declines in key sectors of the economy, especially agriculture. Absent a fast resolution of the political crisis, the Federation of Kenya Employers also warned that economic growth could drop to 3.5% in 2008. Taking a middle-of-the-road position, Standard Chartered Bank on January 15 reduced its growth estimate for 2008 from 6.5% to 5.0%. Similarly, the IMF cut its 2008 economic growth projections for Kenya by only 1% to 5-7%, but warned that this depended on resolving the deadlock within the next two weeks.

Banking and the Budget

¶11. (U) Just as with the wider economy, the impact of the crisis on the banking sector remains to be seen. Kenyan banks, after several profitable years, are awash in reserves and liquidity. It's possible that uncertainty about the economy's prospects could dampen demand for credit in the short term, leading to lower rates. Conversely, banks could become skittish and raise rates to account for greater perceived risk, especially if the farmers and small businesses victimized by the unrest default on their loans.

A Slippery Slope to Recession?

¶12. (U) Some analysts fear this latter effect could generate a recession scenario. The narrative goes like this: The disruption of incomes and economic activity caused by the political crisis could lead to a large number of loan delinquencies and defaults,

significantly reducing liquidity in the banking system. Banks will likely raise rates to reflect greater risk and uncertainty, and be wary of further lending. If the GOK has to increase borrowing and/or offer higher interest rates to cover revenue shortfalls or increased spending for compensation and economic stimulus, banks will gladly put their funds into risk-free government bonds and reduce or stop lending to the private sector, especially to small and medium-sized enterprises (SMEs), a sector which has been a significant source of growth and job creation over the past several years. Bottom line, according to this pessimistic-but-plausible scenario: The economy sinks into a recession.

¶13. (SBU) A key variable in this analysis is whether and how much the GOK needs to expand domestic debt issuance. The GOK's budget for FY 2007-08 already calls for a deficit amounting to 5.3% of GDP. The GOK had planned to cover this gap through domestic borrowing and proceeds from privatization, including the sale in early 2008 of 25% of cell phone giant Safaricom on the Nairobi Stock Exchange. But the much-anticipated Safaricom IPO may be delayed due to the political crisis and resulting uncertainty. If so, the GOK will either have to increase domestic borrowing, or cut back on development spending, neither of which is attractive. In the event it issues more domestic debt than originally planned, it could push up interest rates, crowding out credit to the private sector, as per the analysis above.

International Impact of Crisis

¶14. (SBU) The crisis has clearly damaged one of Kenya's most valuable assets for attracting investment: Its reputation as the most stable, democratic country in East Africa. It is still far too early to assess the actual cost of this damage in terms of lost investment and lost markets overseas (if indeed it can ever be done), but one tangible signal was the decision of Standard & Poor's to cut Kenya's long-term local currency credit rating shortly after the unrest began from BB- to B+. The negative publicity in the international media generated by the unrest now also threatens the Government's painstaking efforts to bring to market a landmark $200-500 million sovereign Eurobond in the first half of 2008. Appetite for the bond in the U.S. and European bond markets was reportedly very strong during a September pre-road show staged by the Ministry of Finance, but it seems very likely that Kenya will either have to postpone the issuance until international perceptions of the country's stability return to normal, or else pay a potentially much higher rate of interest.

Comment and Analysis

¶15. (SBU) The bottom line is that all bets are off and any number of scenarios could emerge in the coming weeks and months - all depending on the political scenario that plays out, and how Kenyans react to it. A genuine political reconciliation between the two political camps in the coming weeks could regenerate economic normalcy and confidence, giving the economy a new lease on life and a shot at maintaining growth in the 6-7% range. Even then, however, some sectors, notably tourism, will feel the pain for at least another six months. If things go the other way and there is prolonged violence and unrest, the recession scenario becomes all too real, as confidence and certainty give way to fear and economic retreat. If the political situation remains in an uneasy status quo, without a breakthrough but also without a great deal of violence or disruption, then the economy does the same - it just muddles through. The economy mirrors the state of Kenyan society at the moment: Teetering between potential breakthrough and potential collapse. Only a month or two ago, the political and economic elite, with a chorus of approval from the international community, were talking about attaining Vision 2030's goal of 10% sustained annual growth for the next 25 years. What a difference an election makes.
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